Montana Law Review

Volume 25
Issue 2 *Spring 1964*

Article 3

January 1964

Montana's Close Corporations - Victims of a Statutory Strangle Hold?

Kemp J. Wilson

NOTES

MONTANA'S CLOSE CORPORATIONS — VICTIMS OF A STATUTORY STRANGLE HOLD?

INTRODUCTION

Close corporation shareholders, unlike their public issue cousins, often find it necessary to enter side agreements to insure that the traditional rules governing corporations do not destroy the intra-business relationships which they have found best suited to their needs. A recent Montana decision, *Sensabaugh v. Polson Plywood Co.*,[1] has given rise to questions concerning the extent to which such agreements may deviate from the norms established by the various provisions of Montana's Corporation Code.[2]

The purpose of this article is to examine the basic characteristics of close corporations, the reasons why traditional statutory norms are often a hindrance to the adoption of the norms deemed necessary for the inner order of a particular close corporation,[3] and the ramifications of the *Sensabaugh* decision for Montana's close corporations.

CLOSE CORPORATIONS "DEFINED"

The four "B" brothers are successful Montana ranchers. Their lands are adjoining, and the brothers have operated as partners for years. They decide to incorporate in order to gain tax benefits and limited liability.[4] The "B" Ranch Company is incorporated under the Montana Corporation Code. The shares are issued as follows: AB, BB, CB, and DB are each issued 20 per cent of the shares, and EB, a non-landowning brother, is issued 20 per cent upon his promise to serve as accountant for the ranch.[5]

[1]135 Mont. 562, 342 P.2d 1064 (1959).

[2]REVISED CODES OF MONTANA, 1947, Title 15. Hereinafter REVISED CODES OF MONTANA will be cited R.C.M.

[3]The phrase ''norms for the inner order'' is an expression of a basic concept used in applying what has been denominated the ''institutional approach'' as an analytical tool in relating legal rules to society's institutions. Briggs, *Investment Securities*, 21 MONT. L. REV. 64 nn.1 & 3 (1959) (citing EHRLICH, FUNDAMENTAL PRINCIPLES OF THE SOCIOLOGY OF LAW (Moll Transl. 1936)). A general explanation of this concept can be stated as follows: Power centers (institutions) in the social, economic and political realm within which we live, be they groups of individuals or ''legal'' entities, which exert some force upon society, have developed rules (norms) within their particular center which have been deemed essential to the continued functioning of the institution in society. The close corporation has developed into a distinct entity in the business world, and hence is such an institution. Through the judicial and legislative processes, these norms are accepted or rejected by society. See text *infra* at note 93 for an adaption of the institutional approach to the legislative process.

[4]See 1 O'NEAL, CLOSE CORPORATIONS § 1.08 (1st ed. 1958), for a discussion of various business situations which may lead to the formation of a close corporation. Hereinafter O'NEAL, CLOSE CORPORATIONS will be cited O'NEAL.

[5]The issuance of EB's shares in exchange for his promise to perform future services illustrates a problem common to many close corporations. Close corporation shareholders often do not have more than a nominal amount of capital to invest, but do

What is the nature of the business entity which the "B" brothers have adopted for the management of their ranching operations? The obvious answer is that by taking advantage of the Montana Corporation Code, they have chosen the corporate form of doing business. However, in examining not only the fact that the corporate form has been used, but also the manner in which the shareholders view their management relationship to one another and with respect to their ownership of the corporation, it appears that the "B" Ranch Company is something *less* than an ordinary corporation. As will be developed, the brothers have formed what the courts[6] and writers[7] have denominated a "close" corporation.

The word "nature" is more appropriate in attempting to explain the basic characteristics of a close corporation than is the word "define". While several attempted definitions are adequate for some purposes, no one of them covers all the aspects which determine "closeness".[8]

Most writers agree that the term "incorporated partnership" is an apt description of the typical close corporation.[9] The use of this term flows largely from the manner in which the shareholders view one another in relationship to the management of the business, and not merely because the association may have been a partnership prior to incorporation.[10] For example, in incorporating their ranch holdings, the "B" brothers did not wish to terminate the function each served in the management of the business prior to incorporation. The term also stems from a basic difference between shareholders in public-issue corporations and close corporation shareholders. Close corporation shareholders nearly always have a vital interest in the management of the corporation.[11] That is, as opposed to the public-issue corporation, in the typical close corporation there is an intertwining of management, or control, and

possess certain skills which are essential to the survival of the business. The possession of such skills is relied upon by shareholders in asking for an active voice in the management via share ownership. Oppenheim, *The Close Corporation in California—Necessity of Separate Treatment,* 12 HASTINGS L. J. 227, 241 (1961). However, the law frowns upon the issuance of shares for future services. MONT. CONST. art. 15, § 10 provides: "No corporation shall issue stocks or bonds, except for *labor done, services performed,* or money and property actually received; and all fictitious increase of stock or indebtedness shall be void." (Emphasis added.) The Montana court in Kirkup v. Anaconda Amusement Co., 59 Mont. 469, 197 Pac. 1005 (1921), ruled that this constitutional prohibition also extends to contracts for the issuance of shares upon the performance of future services. For a critical analysis of this holding, see Note, *Corporations: Validity of a Contract To Issue Stock For Future Services,* 2 MONT. L. REV. 91 (1941).

[6]"The respondent is a close corporation, all outstanding shares of its capital stock being held by members of the same family." Small v. Coca-Cola Bottling Co., 134 Mont. 168, 328 P.2d 124, 125 (1958).

[7]See, *e.g.,* Lattey, *The Close Corporation and the New North Carolina Business Corporation Act,* 34 N.C.L. REV. 432 (1956); Stevens, *Close Corporations and the New York Business Corporation Law of 1961,* 11 BUFFALO L. REV. 481 (1962).

[8]O'NEAL § 1.02.

[9]Latty, *supra* note 7, at 438; Cary, *How Illinois Corporations May Enjoy Partnership Advantages: Planning for the Closely Held Firm,* 48 NW. U.L. REV. 427 (1953); Hetherington, *Trends in Legislation for Close Corporations: A Comparison of the Wisconsin Business Corporation Law of 1951 and the New York Business Corporation Law of 1961,* 1963 WIS. L. REV. 92 (1963); O'NEAL, *supra* note 8.

[10]*Supra* note 8.

[11]O'NEAL § 1.07.

ownership. The "B" Ranch Company is an example of this. The brothers depend upon the ranch as their primary source of income, and therefore naturally wish to have a voice in the management of the business.

It is also generally stated that the stock of a close corporation is not offered to the public, nor listed on any exchange.[12] These limitations also stem from the relationship of the shareholders to each other and to the business, and from the reasons why the corporate form was chosen for the business. That is, as in the case of the "B" Ranch Company, the corporation is not conceived with any notion of allowing the ownership to be spread among the general public. There is a desire to retain the "closeness" which has been achieved.[13] These specific limitations are also the ones chosen by the various legislatures in several encouraging efforts to give statutory recognition to the needs of close corporations.[14]

The above discussion has pointed out several standards which have been used in differentiating between close corporations and public-issue corporations. It is submitted that the source of these various standards is the interest that close corporation shareholders have in the management of the corporation with regard as to how they view one another and also their ownership interests. Perhaps the most concrete example of this proposition is the uncertainty among various writers as to whether the classification of a corporation as "close" should also depend upon the number of shareholders.[15] This uncertainty can be explained in the following manner: The greater the number of shareholders, the less the degree of concern by the individual shareholder for a voice in the management of the business and for his relationship to the other shareholders. That is, the degree of the qualities which form the basic difference between close and public-issue corporations is inversely proportionate to the number of shareholders.[16] This view is supported by the fact that nearly all close corporations have few shareholders.[17] Thus, it would appear that the concern voiced by the authorities is well-founded. While some numerical cut-off point as to the number of shareholders a close corporation may have may be theoretically feasible,[18] any attempt to

[12]Oppenheim, *supra* note 5, at 228.

[13]This statement is often made in discussing share transfer restrictions, which are cited as evidence of such a desire. O'NEAL § 3.56. However, the proposition that the stock of a close corporation is not offered to the public nor listed on any exchange is often qualified by the statement that "there is no established market for the corporate stock . . . ." O'NEAL § 1.07. It is submitted that the lack of a market for the stock also stems from the desire to keep the corporation "closed."

[14]See, *e.g.*, R.C.M. 1947, § 15-1119 (1963); N.C. GEN. STAT. ANN. § 55-73(b) (1960); N.Y. BUS. CORP. LAW § 620(c). However, it should be emphasized that the adoption of these limitations by the legislatures does not mean that they are completely adequate. O'NEAL § 1.14 n.89. At best, they are only general guidelines.

[15]O'NEAL § 1.14 n.89; Latty, *supra* note 7, at 438; Note, *Close Corporations—Strictness of Requirements at Meetings of Shareholders and Directors*, 14 S.C.L.Q. 408 (1962); Oppenheim, *supra* note 5, at 228; Hetherington, *supra* note 9, at 132.

[16]The rate at which an increase in the number of shareholders will cause a close corporation to lose its uniqueness will vary from corporation to corporation, depending upon the nature of the business, the number of shares held by the individual shareholders, and the functions of the various shareholders in the management of the business.

[17]*Supra* note 15.

[18]Oppenheim, *supra* note 5, at 229, suggests that a statutory definition of a close corporation should limit the number of shareholders to ten. This cut-off point was chosen because: "Subchapter S (INT. REV. CODE of 1954 §§ 1371-77) gives shareholders of a corporation having less than ten shareholders an option to be taxed

state such to govern all cases would defeat the goal of giving recognition to the needs of close corporations.

Thus, the "standards" used in evaluating the characteristics of close corporations are but reflections of the intangible, but basic, attitudes of close corporation shareholders towards one another, and towards the management of the business.

STATUTORY NORMS V. NEEDS

The basic concerns of close corporation shareholders, as discussed above, often give rise to peculiar problems in ascertaining the form of internal government which will insure the smooth operation of the particular business. For example, let us suppose that the shareholders of the "B" Ranch Company have the following problems to deal with in setting up the internal structure of the corporation:[19]

(1) AB, being the eldest brother and having contributed the most capital to the corporation, wishes to have the final say as to any shareholder or director action, and also wishes to serve as president of the corporation.

(2) BB is a college graduate, and an experienced cattleman. It is desired that he have exclusive control and discretion concerning all cattle transactions.

(3) It is desired that in the event any of the shareholders bring an action to dissolve the corporation, the buy-out provisions of the Montana dissolution statutes[20] will not be available to the remaining shareholders.

Provisions concerining the internal management, or inner order, of a particular close corporation may be found in the articles of incorporation, by-laws, or in shareholders' side agreements. While it may make a difference where such solutions are found in determining their validity,[21] for the purposes of this article they will be assumed to be provided for in shareholders' agreements.

---

essentially as if they were in partnership. Section 1371(a)(1). It is thought that this ability to avoid the double taxation associated with the corporate form will increase the popularity of the close corporation to low income businesses. It was therefore felt to be advisable to integrate the close corporation regulatory statute with the taxing statute.'' *Id.* at n.10. Montana's Securities Act could also be cited as authority for a cut-off number of ten, as that Act generally does not apply to transactions involving less than ten offerees or subscribers. R.C.M. 1947, § 15-2014(8) & (9) (1963). However, it is submitted that it is impossible to establish a cut-off point as to the number of shareholders a close corporation may have which would satisfy all situations and still be meaningful. See *supra* note 16. Such a limitation is also inconsistent with an expressed desire to give recognition to the needs of close corporations, for a numerical cut-off point will largely only serve to increase the problems of those persons seeking to utilize the ''incorporated partnership'' concept in the management of their business.

[19]These problems are only a representative sample of those which may arise in planning the internal structure of a particular close corporation.

[20]R.C.M. 1947, §§ 15-1101 to -1131 (1963).

[21]Hetherington, *supra* note 9.

Let us assume that the problems of the "B" Ranch Company shareholders, as set forth above, have been dealt with in a shareholders' agreement, entered by all of the brothers, with the following provisions:[22]

(1) It is agreed that in their capacity as directors,[23] the brothers will vote to retain AB as president.

(2) Before any action may be taken by the shareholders or directors, there must be unanimous consent.

(3) BB will have exclusive control and discretion as to any cattle transactions.

(4) *One* or more of the shareholders may sue for dissolution under the Montana dissolution statutes, and in the event such an action is brought the remaining shareholders will not utilize the buy-out provisions of R.C.M. 1947, section 15-1124.

Would any, or all,[24] of the above provisions be upheld by the Montana court if one or more of the brothers were to challenge their validity?

As commonly stated, corporations are creatures of statute.[25] The typical corporation code contains provisions concerning the internal framework of corporations,[26] which envision a "tier" system of internal government for corporations, made up of three levels: Officers, directors, and shareholders.[27] The directors are to manage the corporation's affairs,[28] with the shareholders to have a voice in certain corporate dealings.[29] The directors are usually only controlled by the fact that they are elected by the shareholders.[30] The traditional corporation code

[22]For applicable forms, see O'NEAL § 10.

[23]It is assumed that the by-laws of the "B" Ranch Company have provided for five directors. R.C.M. 1947, § 15-108 provides: " . . . the number of directors shall be fixed by the by-laws . . ." The fact that the directors are the sole shareholders may be determinative in examining the validity of an agreement provision that the directors will elect certain persons as officers. See text *infra* at note 68.

[24]When a shareholders' agreement is held to contain both valid and invalid provisions, the question arises whether the agreement is severable. In Manson v. Curtis, 223 N.Y. 313, 119 N.E. 559 (1918), it was held that an agreement containing a valid provision concerning the election of directors could not be enforced as the agreement's primary purpose was to completely sterilize the board of directors by virtue of a provision vesting complete control of the corporation in one person. However, when the invalid provisions do not involve an impingement upon the statutory norm giving to the board of directors the management of the corporation, the agreement may be held to be severable as to the valid provisions. Wygod v. Makewell Hats, Inc., 265 App. Div. 286, 38 N.Y.S.2d 587 (1942).

[25]Barnett Iron Works Inc., v. Harmon, 87 Mont. 38, 285 Pac. 191 (1930).

[26]R.C.M. 1947, §§ 15-401 to -412 (directors); R.C.M. 1947, §§ 15-501 to -509 (shareholders and directors meetings); R.C.M. 1947, §§ 15-601 to -651 (corporate stock and rights of shareholders); R.C.M. 1947, §§ 15-301 to -303 (by-laws).

[27]Comment, *"Shareholders' Agreements" and the Statutory Norm,* 43 CORNELL L.Q. 68 (1957); Cary, *supra* note 9.

[28]"The corporate powers, business, and property of all corporations . . . must be exercised . . . by a board of . . . directors . . ." R.C.M. 1947, § 15-401.

[29]R.C.M. 1947, §§ 15-901 to -913 (sale of corporate property); R.C.M. 1947, §§ 15-1901 to -1908 (consolidation and merger).

[30]R.C.M. 1947, § 15-401. The shareholders may also vote to remove directors. R.C.M. 1947, § 15-408. The right of a shareholder to bring a derivative suit in Montana to control the actions of directors is thoroughly discussed in Note, *Corporations: Limitations Upon the Right of a Stockholder to Bring a Representative Suit in Montana,* 3 MONT. L. REV. 105 (1942).

is basically sound in its application to public-issue corporations, where ownership is widely held and largely divorced from management.

However, the traditional corporation code in requiring a corporate structure comprised of two seperate factions—ownership and management—does not take into account the needs of close corporations. Therefore, the unity of ownership and management in the close corporation, when coupled with the desire of the shareholders to treat themselves as partners in the business, often requires a deviation from statutory standards in order that the desired norms for the inner order of the particular corporation can be achieved.

It should be noted at this point that the Model Business Corporation Act,[31] and the corporation codes of several states,[32] have recognized the needs of close corporations. Of special interest to the shareholders of Montana's close corporations in this regard are the recently enacted Montana Corporation Code dissolution provisions,[33] which are only applicable to close corporations.[34] Under these provisions, a holder of 25 per cent or more of the outstanding shares[35] may petition a district court for an order of involuntary dissolution when one or more of the following circumstances exist: Abandonment of the business,[36] a deadlock between the shareholders or directors,[37] the directors or those in control of the corporation have been guilty of fraud or mismanagement,[38] minority stock interests have been oppressed to the point where a refusal of dissolution would be unfair,[39] or the corporation's "life" has terminated

[31]The Model Act has been used as a basis, wholly or in part, for the business corporation acts of the following jurisdictions: Alabama, Alaska, Colorado, Connecticut, District of Columbia, Iowa, Maryland, North Carolina, North Dakota, Oregon, Texas, Utah, Virginia, Wisconsin, and Wyoming.

[32]*Supra* note 14.

[33]*Supra* note 20.

[34]"This act shall not apply to any corporation whose capital stock is offered to the public or to any corporation whose stock is listed on any established stock exchange." R.C.M. 1947, § 15-1119 (1963).

[35]"A complaint for the . . . dissolution of a corporation . . . may be filed . . . by the following persons: 1. A shareholder or shareholders who have held not less than twenty-five per cent of the number of outstanding shares for a period of not less than six months." (R.C.M. 1947, § 15-1119 (1963)). It is submitted that the legislature had no rational basis for choosing the twenty-five per cent cut-off point, as the buy-out section (R.C.M. 1947, § 15-1124 (1963)) removes the possibility of corporations being harrassed by extreme minority shareholders. For a discussion of the twenty-five per cent limitation and shareholders' agreements, see text *infra* at note 78.

[36]R.C.M. 1947, § 15-1120(1) (1963).

[37]*Id.* § (2). The comparable Wisconsin dissolution statute provides that: ". . . the shareholders have been deadlocked in voting power . . ." WIS. STAT. § 771(1)(a) (1961). In commenting on this section of the Wisconsin code, Hetherington, *supra* note 9, at 121, states: "There may be some difficulty in determining when within the meaning of the statute the shareholders are 'deadlocked in voting power.' For example, assume that the two shareholders of a corporation respectively own 60 and 40 percent of the outstanding shares. Are the shareholders 'deadlocked in voting power' within the meaning of the statute if the articles or by-laws require . . . [unanimous vote] . . . and the shareholders are unable to agree? In this situation deadlock results from the by-laws or articles provision which effectively equalizes the unequal voting power of the majority and minority shareholders. The article or by-law provision operates as an irrevocable proxy from the majority to the minority shareholder covering ten per cent of the shares. For all practical purposes there is a 'deadlock in voting power.' Yet under the statutory language, it may not be so considered since one shareholder has 20 votes more than the other."

[38]R.C.M. 1947, § 15-1120(3) (1963).

[39]*Id.* § (4).

without an extension.[40] An important provision of the Montana dissolution sections is the buy-out procedure, which serves as a means by which the majority shareholders may avoid dissolution.[41] Even though these provisions raise several questions, by virtue of including the buy-out procedure it would appear that the Montana legislature has gone beyond other states in recognizing the needs of close corporation shareholders regarding dissolution.[42]

However, as previously stated, most traditional corporation codes hinder the attempts of close corporation shareholders to adopt the norms best suited to the internal management of the particular business. For example, the provisions of the agreement entered into by the shareholders of the "B" Ranch Company are seemingly at odds with several sections of the Montana Corporation Code. As to the provisions of the agreement concerning the manner in which the directors will vote, and that BB will have exclusive control of cattle transactions, the Code provides that the board of directors will conduct the business of the corporation.[43] The unanimity provision of the agreement can be compared to various sections of the Code which state that a certain percentage of the vote will be sufficient to sustain particular shareholder or director action.[44] The agreement provision concerning an action for dissolution brought by *any* shareholder conflicts with R.C.M. 1947, section 15-1119, which provides that any holder of *25 per cent* of the stock may bring such an action.[45] The conflict present in the provision nullifying the buy-out option of R.C.M. 1947, section 15-1124 is self-explanatory.

The question posed earlier should now take on added meaning—will the provisions of the agreement, *in deviating from the statutory norms,* be upheld by the Montana court?

JUDICIAL SANCTION OF DEVIATIONS FROM STATUTORY NORMS

The courts have not been in accord as to how shareholders' agreements which deviate from the statutory norms are to be treated. A literal interpretation of the phrase "corporations are creatures of statute", has led some courts to demand a strict adherance to statutory norms:[46]

The State, granting to individuals the privilege of limiting their

[40]*Id.* § (5).

[41]"In any such suit [for dissolution] the holders of fifty per cent or more of the outstanding shares . . . may avoid . . . dissolution . . . by purchasing, ratably in the proportions of their stock ownership, the shares of stock owned by the complaining shareholders at their fair cash value . . ." R.C.M. 1947, § 15-1124 (1963).

[42]Hetherington, *supra* note 9, at 120 to -133.

[43]*Supra* note 28.

[44]See, *e.g.*, R.C.M. 1947, § 15-301 (majority of shareholders to enact by-laws); *id.* § 15-303 (two-thirds of shareholders to amend or repeal by-laws); *id.* § 15-406 (decision of majority of board of directors is valid as corporate act); *id.* § 15-407(3) (three-fourths of shareholders to authorize board to declare dividend from depreciation reserve); *id.* § 15-408 (two-thirds of shareholders to remove directors); *id.* § 15-623 (two-thirds shareholders to authorize sale of no-par stock); *id.* § 15-903 (two-thirds shareholders to authorize sale of corporate property).

[45]*Supra* note 35.

[46]Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829, 831 (1945).

individual liabilities for business debts by forming themselves into an entity separate and distinct from the persons who own it, demands in turn that the entity take a prescribed form and conduct itself, procedurally, according to fixed rules.

However, not all courts have demanded strict compliance with corporation code provisions concerning internal management. The various rationales employed by courts in allowing deviations from the statutory norms have been categorized as follows:

(1) If all the shareholders are parties to the agreement, and there is only a slight deviation, and the public is not injured by the agreement, the agreement will be upheld;[47]

(2) the court refuses to find a conflict between the statutory norm and the agreement;[48]

(3) the statutes in question are directory and not mandatory;[49] and,

(4) the validity of the deviation depends upon the purpose of the statute—if it merely confers a privilege, such can be contracted away.[50]

It must be emphasized that the above list is not meant to be exclusive, nor does the use of one rationale preclude a court from employing the others in determining the validity of shareholders' agreements. This is supported by the fact that even though the courts in sustaining agreements have used language supporting the above categorization, they have commonly employed two concepts: Public policy and protection of the public.[51] The above list merely categorizes the language used by the courts in describing the results they have reached upon considering the agreement in light of public policy and protection of the public.[52]

Will the Montana court approve the patterns established by other courts in sustaining shareholders' agreements which deviate from the statutory norms, or will it adopt the view that the statutory norms must be strictly adhered to as a consequence of adopting the corporate form of doing business?

[47]O'NEAL § 5.06, citing Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936). See also text *infra* at note 65.

[48]O'NEAL § 5.06, citing *In re* American Fibre Chair Seat Corp., 241 App. Div. 532, 272 N.Y. Supp. 206 (2nd Dep't.), *aff'd*, 265 N.Y. 416, 193 N.E. 253 (1934) (shareholders may agree to a system of cumulative voting notwithstanding a statute giving each share one vote). Query whether the *American Fibre* case supports this proposition. It would seem that the court in that case found *substantial compliance* with a statute requiring that the articles be amended in order to allow cumulative voting.

[49]O'NEAL § 5.06, citing Clark v. Foster, 98 Wash. 241, 167 Pac. 908 (1917) (validity of voting trust upheld).

[50]O'NEAL § 5.06, citing Peck v. Horst, 175 Kan. 479, 264 P.2d 888 (1953) (management agreement held valid in spite of statute placing management of corporation in hands of board of directors), and Leventhal v. Atl. Finance Corp., 316 Mass. 194, 55 N.E.2d 20 (1944) (agreement restricting the grounds upon which dissolution could be granted to less than those provided by statute upheld). For an application of this rationale to the constitutional right of cumulative voting, see Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288 (1954); and Sensabaugh v. Polson Plywood Co., *supra* note 1.

[51]*Supra* notes 47-50.

[52]*Ibid.*

SENSABAUGH V. POLSON PLYWOOD CO.

In *Sensabaugh v. Polson Plywood Co.,*[53] the Montana court ruled in a 3-2 decision that a by-law of a public-issue corporation which abrogated the constitutional[54] right of cumulative voting was invalid. However, the court stated in obiter that such could be accomplished through the use of a shareholders' side agreement, but that the by-law could not be treated as contractural in nature. Two judges dissented in part, but for wholly different reasons. One agreed with the court in its dictum, but felt that the by-law could be enforced as a shareholders' agreement among those shareholders who had assented to the by-law.[55] The other felt that cumulative voting could not be dealt with in a shareholders' agreement, for such would contravene the "mandatory and prohibitory" provisions of the Montana Constitution.[56] The reasoning of the majority of the court was that the constitutional provision makes it mandatory for corporations to permit cumulative voting, but that it merely grants a *privilege* to the individual shareholder which he may contract away.

It would appear from the reasoning used by the Montana court in the *Sensabaugh* case that the court may be willing generally to view statutory norms from a "privilege" standpoint. However, it is open to question whether the court will extend its use of the "privilege" rationale beyond the constitutional right of cumulative voting. The language of the court in the *Sensabaugh* decision certainly did not broadly encompass Montana's Corporation Code.[57] Furthermore, the court did not mention two earlier Montana decisions which required strict adherance to Montana's corporation statutes. In the first of these cases, *Glass v. Basin and Bay State Mining Co.,*[58] the court noted that a shareholders' agreement which provided that two shareholders were to be retained as directors and officers of the corporation was void as contrary to a statute giving shareholders the right to elect directors.[59] The second case, *Kirkup v. Anaconda Amusement Co.,*[60] involved a promoter's contract rather than a shareholders' agreement. In examining the validity of the contract, the court noted that the section of the Montana Corporation Code which delegates the management of a corporation's business to its board of directors is mandatory and exclusive.[61] Thus, the rationale

[53]*Supra* note 1.

[54]MONT. CONST. art. 15, § 4.

[55]*Supra* note 1 at 568. For an analysis of this view, see Note, *Corporate By-Law Dispensing With Cumulative Voting Held Void as a By-Law and Unenforceable as a Contract,* 22 MONT. L. REV. 185 (1961).

[56]*Supra* note 1 at 569. See also Note, *supra* note 55.

[57]The court quoted R.C.M. 1947, § 15-405, which states that shares may be voted cumulatively at the election of directors. *Supra* note 1 at 564. However, this section of the code is merely declaratory of the constitutional provision.

[58]31 Mont. 21, 77 Pac. 302 (1904).

[59]R.C.M. 1947, § 15-401.

[60]*Supra* note 5.

[61]"They . . . [directors] cannot abdicate their duties nor permit others to act in their stead for the corporation or the stockholders. This would be direct violation of the injunction of the statute [R.C.M. 1947, § 15-401], which, being exclusive, is also mandatory." *Id.* at 483.

of the *Sensabaugh* decision could well be limited to the provisions of Montana's Constitution which confer privileges upon corporation shareholders.[62]

It is submitted that the *Glass* and *Kirkup* decisions would not prevent the Montana court from allowing deviations from the statutory norms. The *Glass* case, a 1904 decision, is a classic example of the traditional attitude concerning close corporations and statutory norms, as even the plaintiffs in that case conceded the agreement to be void. Thus, the court was not squarely faced with the question of whether a shareholders' agreement may deviate from statutory provisions. The language of the court in the *Kirkup* case that the statutory provision is "mandatory" and "exclusive" does not preclude a finding that a *slight* deviation would be valid.

It would be a foot in the door for Montana's close corporations if the Montana court were to extend the rationale of the *Sensabaugh* case to the provisions of the Montana Corporation Code, and if it is recognized that the use of one rationale does not prevent a utilization of the others in applicable situations, the Montana court could go as far as the courts of other states have gone in upholding the validity of shareholders' agreements which deviate from the statutory norm.

However, this conclusion will not serve as a "cure-all" for the ills caused by statutory norms. Even an enlightened approach to the needs of close corporations in view of traditional statutory norms does not allow close corporation shareholders full latitude in attempting to provide for the internal management of the corporation. As will be seen in examining the validity of the provisions of the "B" Ranch Company shareholders' agreement, full use of the various rationales employed by other courts in sustaining impingements upon statutory norms would, in all probability, still result in the Montana court striking down at least one of the provisions.[63]

INADEQUACY OF JUDICIAL STANDARDS

While those courts which have allowed deviations from statutory norms have done much to give close corporation shareholders latitude in the formulation of intra-corporate policy, judicial exploration of the concepts of public policy and protection of the public has resulted in uncertainty as to how far shareholders' agreements may deviate from the statutory norms. Speaking in terms of the results reached by the courts, the following questions illustrate the confusion: What are the outer limits of a slight deviation from the statutory norm? What constitutes injury to the public? When is a statute merely directory and not mandatory? What determines whether a statute merely confers a privilege? A prognosis of the validity of the provisions of the "B" Ranch Company shareholders' agreement will show that the answers

[62]See, *e.g.*, *supra* note 54, and MONT. CONST. art. 15, § 10, which states: "The stock of corporations shall not be increased . . . without the consent of the persons holding a majority of the stock . . ."

[63]See *supra* note 24 as to the severability of an agreement containing both valid and invalid provisions.

given by the courts to the above questions have laid down few general principles to guide close corporation shareholders in their search for valid norms to govern their corporation's inner order.

In all probability, the provision concerning the retaining of AB as president would be upheld. While the sections of the Montana Corporation Code which are put in issue by this portion of the agreement clearly do not merely grant a privilege to shareholders,[64] this provision can be sustained on a different rationale. The New York court in *Clark v. Dodge*[65] was faced with a similar agreement provision. In that case, all of the shareholders agreed that Clark was to be retained as general manager so long as he continued to be faithful, efficient and competent, and further agreed that he was to receive one-fourth of the profits. The court upheld the agreement with the following language:[66]

> If the enforcement of a particular contract damages nobody—not even, in any perceptible degree, the public—one sees no reason for holding it illegal, even though it impinges slightly upon the broad provisions of section 27 [similar to R.C.M. 1947, section 15-401][67] . . . . Where the directors are the sole stockholders there seems to be no objection to enforcing an agreement among them to vote for certain people as officers.[68]

The provision of the agreement entered into by the "B" brothers vesting exclusive control and discretion concerning cattle transactions in BB, also brings into issue the Montana Corporation Code section vesting the management of corporate business in the board of directors.[69] As previously stated, this section does more than grant a mere privilege to the shareholders. Also, there clearly is a conflict between the section and the agreement. It is submitted that this section of the Code, as well as similar provisions in the corporation codes of other states, cannot be construed to be merely directory in nature. Such a construction would leave the public unprotected in dealing with corporations whose board of directors had been sterilized by such an agreement.[70] This analysis also prevents the provision from being held to be only a slight impingement upon the statutory norm with no injury to the public. The New York court struck down a stronger, but similar, provision in *Long Park Inc. v. Trenton-New Brunswick Theatres Co.*[71] The agreement in that case was subscribed to by all of the shareholders, and delegated complete control of the principal business of the corporation to one shareholder. The court differentiated the case from *Clark v. Dodge* as follows:[72]

[64]*Supra* note 61. *Contra, Peck v. Horst, supra* note 50. The difference of opinion between the Montana and Kansas courts further illustrates that public policy, as interpreted by the courts, underlies the various rationales expressed in examining the validity of agreements which deviate from the statutory norms. See text *supra* at note 51.

[65]*Supra* note 47.

[66]*Supra* note 47 at 642.

[67]*Supra* note 28.

[68]*Supra* note 23.

[69]*Supra* note 28.

[70]This result was intimated in *Clark v. Dodge, supra* note 47.

[71]297 N.Y. 174, 77 N.E.2d 633 (1948).

[72]*Id.* at 175, 77 N.E.2d at 634.

> . . . (T)he powers of the directors over the management of its theatres, the principal business of the corporation, were completely sterilized. Such restrictions and limitations upon the powers of the directors are clearly in violation of section 27 of the General Corporation Law of this state. . . .**** We think these restrictions and limitations went far beyond the agreement in *Clark v. Dodge.* We are not confronted with a slight impingement or innocuous variance from the statutory norm, but rather with the deprivation of all the powers of the board insofar as the selection and supervision of the management of the corporation's theatres, including the manner and policy of their operation, are concerned.

Thus, even though the provision giving BB complete control and discretion in cattle transactions was deemed to be needed for the internal harmony of the "B" Ranch Company, the presently existing Montana Corporation Code may prevent the enforcement of this portion of the agreement. Furthermore, the "B" Ranch Company shareholders have no definite standard by which it can be determined to what extent managerial powers can be taken out of the directors' hands. It has been assumed that cattle production is the principal business of the "B" Ranch Company. Would the agreement provision be sustained if cattle production was a minor income factor for the Ranch and wheat production was the main business? Or, what if the provision placed certain limits on BB's discretion?[73] It is submitted that the Montana court could, upon close examination of R.C.M. 1947, section 15-401, enforce a management agreement internally, and at the same time find that there is no injury to the public.[74]

In the third provision of the shareholder's agreement, the "B" brothers have rejected a portion of the statutory scheme governing the dissolution of close corporations by providing that the buy-out provisions of R.C.M. 1947, section 15-1124 will not be available in the event an action for dissolution is brought by a shareholder. However, it is likely that this provision would be upheld. It is evident from the wording of the buy-out section, and also from the intent of the legislature in enacting the dissolution provisions, that the purpose of this section is to confer a privilege upon the majority shareholders.[75] On this rationale, the Massachusetts court has upheld an agreement provision restricting

[73]"There are suggestions in some of the cases that the validity of shareholders agreements limiting the powers of directors may turn on the number and importance of the powers taken away from them . . ." O'NEAL § 5.16. Query whether the Montana Legislature has, in enacting the close corporation dissolution provisions, expressed as public policy that a partial or total sterilization of the board of directors may be desirable in close corporations. One of the grounds upon which dissolution will be ordered is that: "The directors *or those in control* of the corporation have been guilty of fraud or gross mismanagement." R.C.M. 1947, § 15-1120(3). [Emphasis added]. The phrase "or those in control", when read in conjunction with the term "mismanagement" could well be taken to mean that public policy does not require the striking down of sterilizing provisions.

[74]The public is protected from side agreements which are violated by the agency principle of apparent authority. Latty, *supra* note 7, at 435.

[75]R.C.M. 1947, § 15-1124 states that the majority shareholders "may" avoid dissolution by buying out the complaining shareholder. R.C.M. 1947, § 15-1129 provides: "This act shall be liberally construed in order to achieve substantial justice and safeguard the rights of shareholders and creditors of such corporations."

the grounds for filing for dissolution to less than those provided by statute, reasoning that the privilege afforded by the statute can be contracted away.[76] It is submitted that if the Montana court were to refuse to apply the "privilege" rationale to R.C.M. 1947, section 15-1124, minority shareholders, especially those of Montana's ranch corporations, may find it the lesser of two evils to endure the conditions upon which dissolution could be granted.[77]

The "B" Ranch agreement provision concerning dissolution also raises an interesting question by allowing a holder of *less* than 25 per cent of the stock to sue for dissolution of the corporation. R.C.M. 1947, section 15-1119 states that a shareholder suing for dissolution must have not less than 25 per cent of the number of outstanding shares.[78] The Montana court could well find such a provision to be invalid as repugnant to the express wording of the statute, and also because it would give extreme minority shareholders the power to upset corporate dealings.[79] In view of the buy-out provision[80] and the wish of the legislature that the dissolution statutes be broadly construed, such a result is unlikely.[81] Also, the dissolution statutes not only give a right to sue for dissolution, but they impliedly confer a right to the shareholders to be free from such suits by the holders of less than 25 per cent of the outstanding shares. It should not be hard for the Montana court, in light of the rationale employed in the *Sensabaugh* case, to hold that such rights can be contracted away in a shareholders' agreement. Nevertheless, the validity of such a provision may be more seriously questioned when it is coupled with a provision declaring the buy-out section inapplicable, such as in the "B" Ranch agreement. In such a case the shareholders would have no protection against extreme minority interests, and the protection of the public could be jeopardized.[82] However, as in the "B" Ranch Company, the holdings of close corporation shareholders are often equally divided, or at least are of such a nature that the minority interests are not "extreme".[83]

The provision of the "B" Ranch Company shareholders' agreement requiring unanimous consent for any shareholder or director action seemingly conflicts with many Montana Corporation Code sections which provide that a specific percentage of votes shall be sufficient for share-

[76]*Leventhal v. Atl. Finance Corp., supra* note 50.

[77]In many instances, especially when ranching operations are involved, the capital contributed by the shareholders is property and not cash. For example, four of the five "B" brothers have invested their individual ranch holdings in the corporation. For various reasons, such as a desire to remain in the ranching business on the home place, shareholders may not want what *may* be a cash equivilent for such property upon filing for dissolution.

[78]*Supra* note 35.

[79]O'NEAL § 9.02.

[80]*Supra* note 41.

[81]*Supra* note 75.

[82]R.C.M. 1947, § 15-1129 (1963) states that the rights of creditors are to be taken into consideration when construing the act.

[83]*Caveat:* Many close corporations are formed by utilizing "dummy" directors in order to comply with statutes requiring a minimum number of directors. Such directors often hold only a few shares of stock. See, *e.g.*, Sun River Stock & Land Co. v. Montana Trust & Savings Bank, 81 Mont. 222, 262 Pac. 1039 (1928).

holder or director action.[84] The New York court in the now-famous case of *Benintendi v. Kenton Hotel, Inc.*,[85] declared similar agreement provisions invalid as (regarding shareholder action) "obnoxious to the statutory scheme of stock corporation management" in giving minority shareholders such veto power,[86] and (regarding director action) flaunting "the plain purpose of the legislature in passing that statute."[87] While the *Benintendi* case is open to criticism for its effect upon the needs of close corporation minority shareholders, no attempt will be made to justify this provision of the "B" Ranch Company shareholders' agreement as it serves to point up the difficulties which may arise in applying the various rationales listed above.

Would an agreement calling for a three-fourths vote for any shareholder or director action, as opposed to a statutory norm of a simple majority, be upheld? Or a seven-eighths vote provision? The question of how far an agreement may deviate from statutory voting provisions is largely unanswered by the courts.[88] This problem is inherent in all of the various rationales which have been employed by the courts in allowing or disallowing deviations from statutory norms. The problem may be stated as follows: The rationales employed by the courts are at best very general standards, and except for the specific agreement provisions involved in the various cases, close corporation shareholders have been given no guidelines to follow in formulating norms for the inner order of their particular corporation.[89]

CONCLUSION

The desirability of allowing shareholders in a close corporation to choose whatever form of internal management they find most advantageous to the harmonious intra-operation of the business is evident when the matter is viewed from an institutional standpoint. If the close corporation is recognized to be a distinct institution among business associations, the possibility of its having unique problems to cope with in arriving at a suitable form of internal organization should be relatively obvious. When the close corporation is compared to the association it closely resembles in the eyes of its shareholders, the partnership, and the association whose statutory shell contains it, the public-issue corporation, it becomes clear that the codified norms for the inner order of the public-issue corporation often conflict with the norms found necessary to sustain a particular close corporation as a member of the business world.

The shareholders of the hypothetical "B" Ranch Company, along

[84]*Supra* note 44.

[85]*Supra* note 46.

[86]Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829, 831 (1945). It is to be noted that the "provisions" in the *Benintendi* case were by-laws which had been agreed to by all of the shareholders.

[87]*Id.* at 116, 60 N.E.2d at 832.

[88]Cary, *supra* note 9.

[89]However, at least one writer feels that the lengths to which an agreement may deviate from the statutory norm can be reasonably predicted by the draftsman. Comment, *"Shareholders' Agreements" and the Statutory Norm*, 43 CORNELL L.Q. 68 (1957).

with Montana's close corporation shareholders, have found that their attempts to establish the intra-corporate structure best suited to their needs have been hindered by the presently existing statutory norms. *Sensabaugh v. Polson Plywood Co.*, has not provided a complete answer to this problem. Even if the Montana court were to extend its reasoning in the *Sensabaugh* case to the provisions of Montana's Corporation Code and also use it as a springboard to employ the aforementioned rationales, in examining close corporation shareholders' agreements, it would still be faced with the ambiguity inherent in those rationales. Thus, there are few standards to guide Montana's close corporation shareholders in the planning of their intra-corporate norms.

In order to give the desired latitude to close corporation shareholders so as to allow them to choose the form of internal management they deem best suited to the inner order of the particular business, statutory recognition of the needs of close corporations is necessary.[90] Several states have taken cognizance of the ambiguity of the various judicial standards, by enacting statutes geared to meet the needs of close corporations.[91] It is submitted that statutory recognition of close corporation needs is long overdue in Montana, and that the legislature's efforts to provide an adequate dissolution procedure for close corporation shareholders is a step in the right direction.

Pursuant to a request by the Montana House of Representatives, a committee has been appointed to study possible revisions of the current Montana Corporation Code.[92] It is hoped that in considering any revision of the Code, that the needs of close corporations be considered in the following light:[93]

> Legislatures must do the best job possible of recognizing and giving formal expression in statutory law to desirable business practices which have grown up in spite of outmoded legal doctrines and rules. on the one hand, and of modifying other existing rules insofar as they make impossible the development of desirable business practices and the recognition of important social interests.

KEMP J. WILSON

[90]Stevens, *supra* note 7.
[91]See, *e.g.*, *supra* note 31, and the N.Y. BUS. CORP. LAW.
[92]H.R. Res. 2, 38th Legisl. (1963).
[93]Briggs, *Investment Securities*, 21 MONT. L. REV. 64 n.3 (1959).